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The Globalisation of Inflation and Misguided Monetary Policies

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Many central banks in both developed and developing countries target low inflation rates, either explicitly or implicitly. They believe that inflation results from a monetary excess, driven by domestic fiscal deficits. So they respond to rising inflation by hiking the rate of interest, expecting thereby to dampen aggregate demand and inflation expectations.

Yet much of the recent rise in inflation in both developed and developing countries has not been driven by domestic factors, but by international factors beyond the control of national policymakers. As global trade and capital flows have become more integrated, inflation has become increasingly 'globalised'.

This trend has heightened the risk of misguided national policy responses, especially since monetarism still dominates the mindset of most central bankers. Because of the sharply rising risk of financial crisis and recession in developed countries and an associated marked slowdown of growth in developing countries, a tightening of monetary policies now would only make matters much worse.

Rising Food and Oil Prices

The immediately recognizable causes of inflation (as well as price volatility) have been the coincident increases in food and oil prices. Inflation-adjusted oil prices rose from about US$ 32 per barrel on average in 2003 to about US$ 66 on average in 2007 and then peaked at over US$ 140 by June 2008 before declining significantly since then. After 2006, the world prices of rice, wheat and maize rose dramatically—i.e., by over 200 per cent, over 130 per cent and about 125 per cent, respectively.

Despite recent drops, the prices of both oil and food are likely to remain high in real terms for a while. Oil prices will depend, for example, on how demand responds to a global deceleration of growth. Proven reserves have already peaked and the supply response is likely to be weak.

Such global price shocks have translated into an 'imported' acceleration of inflation for many countries. Countries that are net food or oil importers, especially low-income countries such as Bangladesh, Ethiopia, Mozambique and Senegal, are suffering the most.

The long-term problem is that global supply has not kept up with rising global demand for food and oil. There are a number of causes. For food prices, they range from droughts to higher energy and fertilizer prices to diversion by the US and EU of land and feed stocks to bio-fuels. Heightened speculation by international investors has compounded the recent increases in prices, and their volatility.
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But an underlying structural factor, particularly in developing countries, has been long-standing underinvestment in agriculture. The mistaken advice of multilateral and regional financial institutions is partly to blame. The woeful lack of both public and private investment in agriculture will only be aggravated if central banks in developing countries now resort to higher interest rates.

Who Is Importing Oil?

A common explanation for rising oil prices is the intensifying demand for oil from the rapidly growing economies of China and India. But this focus on marginal trends is misleading. The US is, by far, the world's largest oil consumer, and has been on a binge since the early 1990s.

In addition to producing about 300 million tons of oil, the US imported 582 million tons of crude oil in 2005, 26 per cent of the world total (see Table). Japan, the second largest importer, accounted for 213 million tons, i.e., over nine per cent. Together, the EU countries of Germany, Italy, France, Netherlands and Spain imported 413 million tons, or 18 per cent of the total. In contrast, China imported 127 million tons and India 99 million tons. Together, they accounted for only one tenth of the total.

Largest Importers	Million Tons
United States	582
Japan	213
China	127
Korea, Rep. of	115
Germany	112
India	99
Italy	95
France	84
Netherlands	62
Spain	60
Rest of World	709
World	**2258**

Source: IEA, *Key World Energy Statistics*, 2007, Paris.

Because its domestic oil production has been falling, the US is under increasing pressure to secure global supplies. But until recently, historically low real prices of oil on the world market have constrained investment. Moreover, existing reserves have proven increasingly more expensive to exploit.

Despite its consumption binge and mammoth current account deficit, the US has not responded to global inflationary pressures with high interest rates. On the contrary, the US Federal Reserve loosened monetary policies in 2007 in order to stave off an impending financial meltdown and the US Government followed suit by loosening fiscal policies.

Although food and oil prices are likely to remain high for some time, an intensifying 'globalized' credit crunch could lead eventually to general disinflation. Should developing countries therefore be required now to shoulder the burden of fighting globally generated inflation by raising policy interest rates and inducing their own domestic recessions? In the current global context, this is misguided monetarism run amok.

The contents of this Development Viewpoint reflect the views of the author(s) and not necessarily those of CDPR or SOAS.